INSIGHT

MONTHLY COMMENTARY

May Emerging Markets Debt Update

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Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets and International Equities Groups. In this role, she serves as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals and is responsible for communicating investment strategies, performance and outlook to clients. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, most recently as an EM Fixed Income institutional salesperson. At Morgan Stanley, she also served as the Asia Credit Product Manager, marketing Asian credit products globally to the firm's largest institutional clients. In addition, she spent several years working as part of Morgan Stanley's Institutional Investor-ranked U.S. Credit Strategy research team. Ms. Goodly currently serves on the board of Consano. Ms. Goodly graduated with a BA in Economics from Stanford University.

The external backdrop remained challenging during the month, amidst dollar strength, higher U.S. real rates, uncertainty around trade policy and more recently, concerns about Italy leaving the euro. That said, we would argue that this sell-off is due more to the external backdrop rather than vulnerabilities in Emerging Markets (EM), outside of a few specific countries. The asset class continues to benefit from global growth and relatively loose financial conditions (in spite of Fed tightening and higher U.S. Treasuries). The recent Italy news will also, in our view, have the potential to slow European Central Bank tapering. The differential between EM and Developed Markets growth is expected to widen over the next 12-18 months, and typically that has benefited EM. In addition, the vulnerability around the asset class has declined, particularly when compared to the taper tantrum period. Furthermore, the tail risks around China, in our view, have declined compared to several years ago, due to tighter controls on capital flows, well-executed currency management, and a pickup in export growth. Of course, there are risks of policy errors, but we believe the economic impact of trade tariffs on near-term Chinese growth to be limited, as only 3.5% of Chinese output is consumed in the U.S.

Rising policy uncertainty over trade and investment barriers is likely to dampen business sentiment and capex, though we believe this will hit businesses in the U.S. harder than in China, given China's capacity to enact counter-cyclical policies. A widening in the growth premium for the U.S. vis-a-vis the rest of the world would be USD positive, generally a negative factor for EM currencies, particularly for those countries, like Turkey, that rely on external funds flows to finance fiscal and current account deficits.

We would argue, however, that much of this has been priced in and we are also starting to see the market stabilize. There are signs that the move higher in short-term U.S. rates is starting to lose momentum. Pressure on LIBOR-OIS spread has also eased steadily since the end of last quarter.

Emerging Markets dollar-denominated spreads are 60 basis point (bps) wider this year and EM currencies are down ~30% versus the dollar on average since the time of the taper tantrum. The dollar rally has largely been driven by the euro repricing, with most EMFX markets outperforming the euro in May (the exceptions being specific markets with local headline risk, or markets more tied to the Eurozone). While there certainly may be these periods of counter trend dollar rallies, we do not see the case for sustained and continued dollar strength, especially considering the fact that EM growth is outpacing U.S. growth and periods of twin deficits in the U.S. are usually associated with dollar weakness. In addition, rising policy uncertainties in the U.S. are likely to weigh on the dollar, in our view.

Current spread levels appear to be at an interesting entry point, particularly in light of the continuation of strong EM fundamentals. And despite overall market outflows, we continue to see interest to add to the asset class. That said, we do not dismiss the concerns around trade policy and this counter trend rally in the dollar. Security selection and country differentiation remain key in this environment. ■